Attachment

Detailed Comments of the Department of Water Resources on the Bureau of State Audit's Report on the Department's Power Purchase Program

December 10, 2001

OVERVIEW

Contained herein are the detailed comments of the California Department of Water Resources the California Bureau of State Audits draft report "California Energy Markets: Pressures Have Eased, but Cost Risks Remain," December, 2001 ("the Report"). While DWR had less than 2 weeks in which to review, respond and prepare these comments on the 280-page report, our comments on the findings and conclusions within the report are substantial. We provide these comments in the interest of clarifying to both the Bureau, and other parties reading the report, the role of DWR and the reasonableness of its actions and decisions. We also wish to inform the Bureau of the progress made by DWR toward implementing many of the recommendations noted in the report. In addition to providing a status report on the actions taken by DWR to improve its operations and management activities, we also provide here recommendations for policy and operational changes that need to be made by parties, other than DWR, that are critical to maintaining the reliability of the State's electricity system at the least possible cost.

Before providing our specific comments on the Report, we wish to acknowledge the extraordinary task that the Bureau and its consultants faced in performing their analysis. It is clear that the authors of the Report have spent a substantial amount of time in evaluating the circumstances surrounding DWR's performance in implementing Assembly Bill 1X. The difficulty of this task was compounded by the Bureau's consultant's unfamiliarity with the dynamics and dysfunction of the deregulated market in California. Given this lack of experience and familiarity with the dynamics of a deregulated market on the part of the authors, it is understandable that they would mistakenly draw conclusions about the functioning of the California market based upon their experience in evaluating regulated electricity markets in other regions. Clearly, it is erroneous to draw parallels between the power supply decisions of a vertically integrated regulated utility which has a guaranteed rate of return on investment and an obligation to serve customers, to the supply decisions made by DWR in a dysfunctional market environment where merchant generators are pricing their product consistent with perceived, or manufactured, market risk, and have no obligation to serve customers.

We also wish to point out that there is a significant disconnect between the more balanced and reasoned analysis contained within the text and the conclusions and the

chapter headings in the Report. The text of the Report recognizes the extraordinary circumstances surrounding the entrance of DWR into the market and the crisis environment in which decisions had to be made. This was not a time that allowed DWR to indulge in contemplative deliberation. The Report's analysis gives credence to the limitations that DWR was operating under, and what DWR could reasonably achieve given these limitations. The Report's chapter headings, and conclusions and recommendations, however, do not convey the balanced perspective in the text.

Key Concerns

Within the Report, DWR finds that the analytical approach used, certain observations, and key conclusions made to be fundamentally flawed based on (i) basic misunderstanding of DWR's role and mandate; (ii) a failure to appropriately acknowledge the circumstance beyond DWR's control that limited our ability to act more effectively; and (iii) misrepresentation of fact. These key concerns are as follows:

1. The failure of Report to use an appropriate standard for evaluating the success of DWR's actions and the reasonableness of its decisions when the Legislature provided that standard in AB 1X.

2. The conclusion that DWR's supply portfolio does not provide a reliable supply when supply reliability has actually greatly increased.

3. The mischaracterization of DWR as the "energy provider of last resort" when the Independent System Operator has always legally held that responsibility.

4. The criticism of DWR for failing to adequately plan for new power plant development after 2002 , while at the same time criticizing DWR for entering into too many contracts for too much energy.

5. The criticism of DWR for not coordinating better with the California investor-owned utilities and ISO when those entities refused to fully cooperate with DWR.

The Legislature in AB 1X Provided Both the Standard for Evaluating DWR's Actions and the Conditions for Judging the Reasonableness of Its Decisions

One of the principal objections of DWR to the analysis within the Report is that the authors have failed to identify an appropriate standard for evaluating DWR's performance and success in implementing the objectives of AB 1X. The Report considers the circumstances of the energy emergency almost as an afterthought. In fact, the primary purpose of AB 1X was, first, and foremost, to avert an unparalleled disaster to the State, to its economy, and to the health and safety of its citizens. By any measure, DWR's team, under the most daunting and unfavorable circumstances, succeeded in its primary mission of turning around a situation that posed the gravest threat to this State.

The Report never considers what would have happened if DWR had not succeeded in its primary mission. The consequences to the State of not succeeding provide the key to understanding the kinds of measures and the readiness with which DWR responded. In short, they are central to the evaluation of DWR's performance, which is, ostensibly, the purpose of this audit.

This audit was authorized by Water Code Section 80270 to assess the performance of DWR in implementing Division 27 of the Water Code, enacted by AB 1X to address the State's energy crisis. While the audit quite properly includes observations and recommendations of a general nature that can be helpful in future crises, it fails to use the appropriate standard for evaluating DWR's performance in carrying the statutory purposes of Division 27.

The purpose of Division 27 is set forth in its initial provisions. In Section 80000(a), the Legislature set forth in clear and explicit terms the State's urgent need for "reliable and reasonably priced energy" in a situation in which the State had suffered a *"rapid, unforeseen shortage of electric power and energy"* and *"substantial increases in wholesale energy costs and retail energy rates"*. It was, in the Legislature's continuing words, a situation of *"immediate peril to the health, safety, life and property of the inhabitants of the State"*. In Section 80000(b), the Legislature described the need for DWR to *"adequately and expeditiously undertake and administer the critical responsibilities established in this division"*.

In fact, the State was in the midst of an unprecedented crisis. California faced an incalculable energy shortage. There were daily emergency alerts from ISO; blackouts; approximately one-third of the State's generation capacity was off-line; and the cost of electricity and natural gas to generate electricity was skyrocketing. Wholesale electricity prices went from $15 to $30 per megawatt hour to between $300 and $1,000 per megawatt hour. In addition, the Federal Energy Regulatory Commission was unwilling to reign in wholesale electricity prices. The key market for transacting electricity, the California Power Exchange, was out of business. The two largest public utilities in the State (and nation), Pacific Gas & Electric and Southern California Edison, who provided retail electricity to two-thirds of the State, were financially insolvent and unable to buy electricity to serve their customers. When the Legislature passed AB 1X, the crisis had already prompted a Governor's Proclamation of a State of Emergency.

Disruptions in electrical energy service posed an ongoing threat to the health and safety of the citizens of the state. The State's economy—the 5th largest in the world—was in serious peril from blackouts and runaway energy prices. Furthermore, if the situation could not be turned around, the State of California, having to step in to buy electricity itself–at the rate of up to two billion dollars a month from the State's General Fund–was in jeopardy of financial ruin.

An objective evaluation of DWR success in meeting the goals set forth in Division of 27 of AB 1X must consider the crisis environment under which DWR was operating; the magnitude and unprecedented nature of the crisis; the relative limited staff

resources available to DWR, and the need to respond quickly. The auditor's evaluation should also have taken into account that before DWR could begin to act it had to create, from nothing, the basic institutional and logistical infrastructure needed to procure and schedule electricity on an daily, hourly, and real-time basis. The Report should have considered all of the above factors in its appraisal of DWR's performance.

In addition to the *statutory purpose* and the *difficult circumstances* noted by the Legislature in AB 1X, the Report should have expressly recognized the *discretion* AB 1X understandably vested in DWR to choose a path for combating the crisis. Section 80100 sets forth not one but several broad criteria to guide DWR's purchase of electricity under AB1X, "on such terms and for such periods *as the department determines* and for such prices *as the department deems appropriate"*. The question for the auditor's appraisal of DWR's performance should not be, "Could something different have been done?" but rather, "Did DWR, given all the extenuating circumstances, act in a reasonable manner?" Again, Section 80100 sets forth several criteria that must, as a matter critical to both statutory interpretation and fairness, be understood as providing the relevant benchmark for measuring the success or failure of DWR's actions.

DWR's Supply Portfolio Provides Reliable Supply

One of the major themes of the Report is that DWR's power contracts do not provide for reliable deliveries of energy in the future, in circumstances where the then-current spot market cost of energy is higher than the contract price. The Report states this theme as a factual conclusion repeatedly. DWR disagrees with this opinion. DWR respectfully suggests that the Bureau reconsider its conclusion on this point after considering more fully the provisions that are set forth in the contracts for liquidated damages, the purposes of the contracts and the circumstances in which they were negotiated.

The power purchase agreements executed by DWR generally provide for the payment of liquidated or cover damages by the seller in the event that the seller fails to deliver energy pursuant to the agreement. The liquidated damages which are payable to DWR by the seller are equal to the difference between (i) the price DWR would have to pay to "replace" the energy which the seller was obligated to deliver; and (ii) the contract price which would have been payable by DWR had the seller actually delivered the energy.

For example, if a PPA provides for a $80 per MWh price, the seller fails to deliver, and DWR replaces the contracted-for energy with spot market purchases at $200 per MWh, the seller would be obligated to pay DWR $120 per MWh for the contracted-for amount of energy. As a result, the payment of LD's will permit DWR to receive the amount of energy contracted for at the contract price. In the event that the seller failed to pay the LD's that it owed to DWR, DWR could terminate the agreement, and the seller would be obligated to pay "termination liquidated damages".

Termination liquidated damages, which would be payable to DWR, are generally equal to the present value of the difference between the then-current market price for the contracted-for amount of energy and the contract price for the entire remaining term of the agreement, payable in a lump sum. Depending on the magnitude of a contract, termination liquidated damages could be hundreds of millions of dollars or more.

The basis for the report's conclusions concerning LD's (and reliability in general), appear to be based on the speculation that sellers will repeatedly elect to not deliver energy, and instead choose to pay liquidated damages. The presumed theory underlying the seller's behavior is that they will do this because they can potentially make more profit by selling the contracted-for energy (and additional energy the seller may control) in the spot market (even taking into account payment of the liquidated damages) than they would make by selling the energy to DWR. The Bureau's consultant argues that it may not be possible for DWR to replace energy at any price, and that therefore LD's do not provide sufficient incentive for a seller to meet its obligation to deliver energy, hence the Report's conclusion that such supply is not reliable within the meaning of AB 1X.

DWR believes that it is extremely unlikely that sellers would act in the manner contemplated by the Bureau's consultant, given the risks to the seller inherent in such a strategy. Stated simply, at the time that a seller elected not to deliver—and instead to take on the obligation to pay liquidated damages—it would not know what the department's replacement costs would be. Sellers are generally risk averse. If a seller elects to pay LDs, it would be at risk for, and have no control over, the cost of replacement energy as purchased by DWR. This risk to the seller would be greatest in situations where supply is scarce, in that the availability of spot market purchases for marginal amounts of energy is most unpredictable and the cost expensive. It is not reasonable for the Bureau to base its conclusions on a theory that sellers will act in a manner that entails risk of this magnitude. In fact, the theory is not consistent with the actual seller behavior.

During the initial critical months of California's crisis in which DWR's contracts were in place the contract price for energy was less than the then-current spot market price yet no sellers elected to pay liquidated damages, rather than deliver energy pursuant to their contract. Despite the fact that the consultant's basic theory is disproved by actual results, the theory remains as the backbone for a significant part of the Report, and is stated and restated as fact, rather than speculation.

The Report further suggests that DWR's contracts should have contained a right to terminate for non-delivery in order to assure reliable deliveries. If the greatest supply uncertainty, with respect to seller performance, occurs when the contract price is lower than the then the current market price, then termination of the agreement would benefit the seller. Presumably, the seller (freed from the contract) could make sales in the spot market at prices higher than the contract. This could theoretically be avoided by requiring the seller to pay the potentially massive termination liquidated damages described above. However, because of the magnitude of the termination liquidated

damages, it is unreasonable to conclude that sellers would generally agree to pay such termination damages unless they also retained the right to avoid termination by paying LD's.

During the contracting process, DWR consistently demanded that sellers provide contractual assurances that DWR would receive the contracted-for energy at the contracted-for price. LD's, coupled with the termination liquidated damages described above and the other provisions of the contract, achieves that goal.

DWR also notes that the scenario, which the Report claims represents a significant supply risk—spot market prices consistently exceeding the contract price—, would not occur anytime in the near future given the significant additions of new generation capacity in California and other western states.

The Department Was Never Given the Responsibility of Being the Energy Provider of Last Resort

Under AB 1X, DWR was solely authorized to purchase energy to cover the net short demand of the State's IOUs. (The net short demand is the IOU load not served by the IOU retained generation and contracts.) DWR was never given the legal responsibilities of the "provider of last resort" as the Report contends. Yet, the Report unfairly measures DWR contracts against those of a provider of last resort.

That incorrect assessment leads to a near continuous criticism of DWR's contracting methods. First, the Report takes issue with the failure of DWR, as provider of last resort, to use an industry standard agreement. DWR considered many contracting options before it ultimately settled on the Edison Electric Institute Master Power Purchase Agreement. In spite of the Report's comments to the contrary, the EEI Agreement is <u>the</u> model contract widely used in the industry. It is applicable for long-term power sales of standard products. The agreement was developed over a two-year period resulting from a collaborative effort of utilities, generators, marketers, brokers, regulators, credit bankers, fuel suppliers, and others.

Likewise, the Report criticizes DWR's decision to have "cover damages" (firm liquidated damages, or LDs) be the recourse against a seller's failure to deliver energy. The Report asserts that use of LDs was not suitable given DWR's role as the State's "energy provider of last resort". DWR always believed that ISO had the legal responsibilities of a provider of last resort. This view was upheld by FERC in their Nov. 20, 2001 Order.

DWR has no Legal Obligation to Procure New Supplies Post 2002

In several instances, the Report criticizes DWR for not planning for the development of additional power plants beyond 2002. The Report specifically criticizes DWR for not providing for contracted power supplies through 2010, noting that the amount of power under contract after 2005 starts declining, leaving an increasing amount of power supply to the spot market or other sources which are uncertain. This criticism displays a total lack of understanding of DWR's responsibilities under AB 1X and is at odds with the author's claim that DWR entered into too many contracts for too much energy, and that lower cost power would be available through the spot market.

Under AB 1X, DWR has no authority to enter into any contract for any purchase of any amount of energy for any purpose whatsoever after January 1, 2003 [Chapter 5, Termination of Authority to Contract]. DWR's role after 2002 is for the administration of existing contracts that were entered into prior to 2003. DWR's procurement of energy was solely as a transitional role until the IOUs are again creditworthy, the market is stabilized, and the IOUs or some other entity in a future restructuring of the California market assumes the purchase of net short energy.

As was noted in DWR's two requests for bids in January and February 2001, DWR preferred contracts for a term of three years or less. This preference was based on load and resource forecasts in early 2001 that indicated a return to surplus generation capacity reserve levels by 2003 or 2004. As long as there was reasonable financial assurance that power supplies would come on line to meet the 2003-2004 need, it was reasonable to assume that normal market forces and creditworthy utilities in the market would create a continued market for new power supply additions after 2004.

Unfortunately, suppliers were unwilling to offer power supply contracts that contained terms that offered both sufficient quantities at favorable prices for terms of three or even five years. In addition, many of the proposals for power supply were associated with new generation units that depended on the revenue from DWR contracts in order to secure financing. In most of those cases, sellers were seeking ten-year or even longer terms to satisfy lenders. If DWR's preferences for shorter term contracts had been met by the market, the amount of the net short energy needs after 2004 to be served by either the spot market or new long-term contracts to be entered into by the IOUs in 2003 or beyond would be significantly greater.

The Report's contention that DWR should have entered into more contracts for a greater portion of the net short capacity needs beyond is simply inconsistent with the direction of the Legislature in AB 1X to achieve an overall portfolio of contracts for energy resulting in reliable service at the lowest possible price per kilowatt-hour. This position is also inconsistent with the public statements made by the California Public Utilities Commission, which has voiced its desire for virtually all of DWR's contracts to be terminated as of the 2004 or 2005 timeframe if it were possible to do so.

DWR Requested and did not Receive the Full Cooperation of the IOUs and ISO

DWR recognizes that it is only one of several parties with a responsibility for the procurement and delivery of electricity in the State. From the onset, DWR sought to establish working relationships with the major market participants, each of whom have their own mission independent of DWR. Resolution of the many issues faced by DWR required getting information and agreement on major issues from these parties. The Report is either silent on these varied and complex relationships, or suggests a simplistic approach in which all parties initially agree on the resolution of significant, large dollar issues. Given each party's different mandate and legal responsibilities, this simplistic approach is not feasible. DWR has ongoing, meetings and negotiations on varying issues with the following parties:

- ISO, which is subject to the purview of FERC, and thus guided by federal regulations and not required to assist in the administration of AB 1X.

- CPUC, which interprets its roles and responsibilities under AB 1X differently than DWR.

- IOUs, whose dealings with DWR are subject to CPUC, and in the case of PG&E, direction and rulings of the Bankruptcy Court.

-

DWR believes that the Report is especially unfair in its criticism of DWR for not coordinating better with IOUs in integrating the power supplies under DWR's contract with the utility retained generation. The Report cites the benefits of optimizing the use of the URG to meet ancillary services (capacity reserves), and molding the operation of such flexible resources as hydroelectric power plants around DWR's purchases to enable a more cost effective supply. DWR could not agree more. Optimization of the value of URG and DWR's contracts requires a three-way coordination between DWR, each respective IOU, and ISO. Neither IOUs nor ISO have provided such cooperation despite repeated requests from DWR. Without cooperative parties, there can be no coordination.

IOUs have steadfastly been unwilling to provide information on their plans for dispatch of their URG. Even when DWR agreed to furnish or fund the costs of all of the ancillary services not otherwise provided by the IOUs' own generating resources, SCE and PG&E have both refused to develop plans to coordinate their hydroelectric plant operations to optimize the combination of net short energy generation and ancillary services provision. The IOUs have stated that they have no economic incentive to perform such optimization due to CPUC rules regarding their compensation for operation of their generation resources.

Compounding this lack of IOU cooperation is the total lack of cooperation by the ISO. If DWR could not receive information from IOUs regarding their operation of URG resources, ISO could have provided IOUs schedules for such operations to DWR to

both plan around and dispatch around. ISO, citing its FERC tariffs, repeatedly refused to provide this information to DWR. ISO maintains that DWR is a market player like any other and has no right to the confidential information of another market player's (in this instance the IOUs) scheduling information.

Thus, while a coordinated effort between IOUs and DWR to optimize the value of the URG and contract resources to ratepayers through an integrated dispatch procedure makes ultimate common sense, neither IOUs, ISO, or even FERC will allow this to happen. The Report fails to acknowledge this and instead criticizes DWR for this lack of coordination. DWR has no authority to compel IOUs or ISO to cooperate.

Events Have Overtaken the Recommendations in the Report

The Report makes a number of recommendations for actions that have already been initiated by DWR. Examples of these circumstances are provided here.

Assessment of the Contracts – The Report recommends that DWR undertake an assessment of its contracts. DWR began in September to perform a systematic economic review of its contracts similar to that recommended in the Report. Such an evaluation is typical for any holder of a portfolio of power supply contracts. DWR has regularly evaluated the contracts for performance in accordance with the terms, comparison of the contract price to the market, assessment of the accuracy of invoices, and related evaluations. This evaluation has included a comparison of the portfolio to the projected needs for net short energy and ancillary services as the shape and needs of the customers of IOUs have changed with the increased opportunity for direct access by IOU customers based upon the September 20, 2001 decision by CPUC regarding suspension of direct access.

Contract Renegotiation Strategy – The Report recommends that DWR develop a strategy for renegotiating its contracts. In October DWR commenced development of a renegotiation strategy, based in part upon the systematic evaluation of the contracts noted above. Legal counsel is assessing this evaluation and associated actions and discussions with DWR's contract counterparties are planned.

Legal Contract Management Strategy – The Report recommends that DWR proactively manage its legal risks. Since September, DWR has added six additional legal counsel to its team, including three additional internal counsel reassigned from other duties and three outside counsel. These attorneys have the responsibility for evaluation of contract compliance, assessment of the rights of DWR under the contracts, and litigation specialists in the event of challenge by counterparties.

Focus on Short-Term Transaction Operations – The Report recommends further development of DWR's short-term transaction operation. DWR commenced efforts in September to focus on the difficulties that have been created by the lack of cooperation by ISO and IOUs in the real-time energy and ancillary services coordination and settlements process. DWR established a team composed of its accounting, energy

advisors, internal and outside counsel, and its settlements staff to take the initiative to modify the arcane ISO settlements process as it pertains to purchases and credit-backing by DWR to foster more rapid payment to market participants and to avoid double invoicing that had been occurring by ISO. A process to break this settlements logjam had been developed with ISO, had the tentative agreement of IOUs, and was being reviewed by the sellers into the ISO markets in October. On November 7, 2001 in response to a petition by a group of generators, FERC ordered ISO to invoice DWR for all charges ISO believed were owed to it by IOUs. This order negated three months of intense efforts and negotiations to correct the troublesome ISO settlements process. DWR has made the initial required payment on a November 21, 2001 invoice received from ISO. The FERC and ISO actions will likely establish another round of assessment of the procedures for ISO settlements.

Collaboration with the IOUs and CPUC on Rate Incentives for Dispatch of the URG – The Report recommends collaboration with IOUs and CPUC to achieve least-coast dispatch. The matter of rate treatment for the IOUs URG is being addressed in a formal proceeding before the CPUC (A0011056). The matter of collaboration and coordination of the dispatch of URG has been expressly included in the discussions pertaining to the ISO settlements process. The November 7, 2001 order by FERC and the subsequent ISO invoice of November 21, 2001 effectively obliterated any achievements made between DWR and IOUs on negotiating arrangements for proper incentives for payment by autocratically requiring DWR to fund any and all ISO charges regardless of merit or DWR's responsibility for such charges. Despite this setback completely outside of DWR's control, DWR remains committed to working with IOUs, ISO, and CPUC in developing the proper incentives for IOUs to dispatch its URG in a manner which those power resources and DWR's contracted supply can be reasonably optimized. The constraints of the ISO system and its operating protocols and real-time market structure has been and is expected to continue to be a major obstacle to such optimization.

Legislative Action to Extend the Department's Role to Assure Transition – The Report recommends that the Legislature develop an appropriate statutory framework to extend DWR's purchasing. DWR has already commenced a program targeted to assure timely transition of its role as power purchaser of the residual net short (the remaining net short after consideration of DWR's contracts) to others. The Legislature may select other parties for this purpose, but absent such alternative Legislative direction, DWR has assumed that IOUs will resume the obligation to purchase the net short upon their achieving creditworthy status. The timing of the transition is not fully certain, given the uncertainty of the resolution of the PG&E bankruptcy and the time it requires SCE to implement the settlement process negotiated with CPUC in October. However, it is likely that SCE will become creditworthy prior to DWR's January 1, 2003 sunset provision of AB 1X. The timing of the PG&E bankruptcy resolution is unclear, although it is possible that PG&E could resume the purchase of net short energy with the bankruptcy resolution pending if the retail customer revenue for such payments could be satisfactorily protected from other creditor claims. San Diego Gas & Electric Company could return to the role of purchasing the net short having received its rate

adjustment. The issuance of DWR's bonds for payment of energy purchases will likely be a necessary precursor to returning the three IOUs to the position of purchasing the residual net short due to the positive effect this bond issue is expected to have on the California energy market in general.

CPUC has initiated a proceeding to address the process by which IOUs would return to the role of purchasing the net short. DWR is cooperating with the CPUC staff in evaluating the method by which DWR's contracts, IOUs' URG, and the residual net short purchases can be combined in a manner which accelerates this transition.

Other matters being addressed by DWR in this transition effort, as well as being a part of proper disclosure for DWR's bond issue include the need for proper planning and implementation of, but not limited to, the following:

- overlap of DWR trading floor operations with those of IOUs to effect a smooth transition;
- information systems coordination and data transfer;
- clarification of coordination of dispatch responsibilities among DWR, IOUs and ISO;
- ISO, IOU, and DWR settlements coordination; and
- off-system sales coordination.

Retention of Legal Counsel for State and Federal Regulatory Issues – The Report recommends DWR retain counsel to advise DWR on matters associated with State and federal regulatory matters affecting the power-purchasing program, distinct from the interests of the State Water Project. DWR already has multiple legal firms advising on such matters. DWR is represented in State regulatory matters by the law firm of MBV Law, which is separate and distinct from matters associated with the State Water Project, in that the State Water project has no role with CPUC. The firm of GKRSE represents DWR on FERC matters. The fact that counsel may also advise the State Water Project on federal matters not pertaining to the role of DWR is irrelevant. Using counsel familiar with the California market and the respective roles of IOUs, ISO and DWR is simply efficient business practice.

Seek Clear Authority to Use Financial Instruments to Manage Transaction Risk – DWR agrees with the Report's recommendation to gain clear authority to use financial instruments to manage gas and electric transaction risks. DWR is in the process of obtaining legal clarification from the State Attorney General's office of the existing statutory authority vested in AB 1X for this very purpose.